

SINGAPORE CA QUALIFICATION (FOUNDATION) EXAMINER'S REPORT

MODULE: Financial Management (FMF)

EXAMINATION DATE: 13 December 2018

Section 1

General comments

December 2018 exam session was the first time Candidates used e-Exam software, with each of them recording their answers using their personal laptop (in full lockdown mode – no internet/network connectivity or hard drive access) instead of traditional pen and paper. Notwithstanding the use of laptops, all SCAQ Foundation Module examinations continue to be a restricted open-book format with Candidates being able to bring in a double-sided A4 page of personal notes for reference.

Generally, Candidates did well. However, it has been observed that some Candidates who did well for quantitative questions (Question 1 and Question 2) did not fare as well in Question 3 and Question 4 which are more qualitative, and vice versa.

It is not sufficient to simply learn how to perform calculations. A well prepared Candidate also understands the calculations and their implications. As has always been the case, Candidates who cannot answer discursive questions will struggle to pass this paper.

There were some Candidates who could not grasp the basic Financial Management concepts. For example, a few Candidates showed an absolute dollar amount as cost of capital instead of a percentage. The percentage of Weighted Average Cost of Capital will be regularly examined in this paper.

This cohort of Candidates showed a diverse mix from mediocre scorers to high performers.

Section 2

Analysis of individual questions

Question 1

Question 1 was on project decision and cash flow analysis of a commercial real estate company in Singapore. It was a relatively straightforward question with the application of project investment decision making analytics using Net Present Value (NPV) and Internal Rate of Return (IRR). Furthermore, Candidates were also required to run basic sensitivity analysis.

Part (a) focused on the basic understanding of investment appraisal by computing the present value of the contract. Most Candidates performed poorly for this question as they were unable to compute the NPV correctly.

Common mistakes made were:

- Adjusting the initial investment instalment in the second year for inflation;
- Did not adjust for inflation on the scrap value associated with the investment;
- Did not adjust for inflation on working capital;
- Using the full working capital amount instead of the change in working capital;
- Adjusting the labour cost for inflation when no adjustment was required as labour costs were stated in nominal terms; and
- Applying an incorrect discount rate to discount the cash flows.

Part (b) tested Candidates on their critical thinking whereby Candidates were required to compute the percentage change in project price that would change the decision made in **Part (a)**. A large number of Candidates did not solve this question in the straightforward way of either using the net present value (NPV) already calculated in **Part (a)** and dividing it by the present value (PV) of the project price or calculating the future value of the project's NPV and dividing it by the project's price. Many Candidates set the NPV to zero and solved for the price of the project instead, which is a more roundabout method. Nonetheless, they were given full credit. A number of Candidates did not attempt this question.

A common mistake made by Candidates was to use the NPV (numerator) divided by the project price (denominator). This is incorrect because the denominator should be a present value so as to match the NPV in the numerator.

It was noted that some Candidates might not have understood the concept of cost of capital because they provided an absolute dollar amount instead of expressing it as a percentage.

Part (c) asked Candidates to estimate the internal rate of return (IRR) and conclude whether the project should proceed. Many Candidates forgot about the last part of the question, which was to conclude whether the project should proceed. Concluding is one of the easier marks available. Candidates should re-read the question before moving on to the next one, to ensure the actual questions has been explicitly answered on the page.

Part (d) was a straightforward question asking Candidates to list 2 advantages and 2 disadvantages of NPV as compared to the IRR measure. A common mistake made by most Candidates was to list the advantages and disadvantages of NPV in isolation without comparing with IRR, which was not what was asked for. A number of Candidates listed advantages or disadvantages of NPV which were also applicable to IRR, such as taking into account of time value of money. This would not count as an advantage of NPV because IRR also takes into account of time value of money.

Question 2

Question 2 focused on how a Singapore listed aerospace company should finance an expansion plan. The platform for this question was the fundamentals of equity compared to debt, computing WACC and basic benchmarking. The elevated level of application required knowledge of contingent convertibles or preference shares as alternative sources of capital financing.

Part (a)(i) was a simple and direct application of WACC. Candidates did reasonably well for this question and a number of Candidates scored full credit. Most errors pertained to the calculation of the cost of equity such as calculating the growth rate or ex-dividend share price, and in the weighting of the WACC for preference shares and ordinary equity. Some casting errors were observed.

Many failed to state the correct assumptions and used the wrong denominator in **Part (a)(ii)**. Some Candidates failed to attempt this question part.

Part (b) was fairly straightforward and a number of Candidates scored full credit. However, some Candidates did not attempt this question. Most Candidates were able to identify the increase in the cost of debt and the amount. However, some Candidates forgot to take into account the effect of taxation. Some Candidates were able to correctly state the impact on WACC but they were unable to arrive at the correct conclusion, while some Candidates did not highlight the impact on WACC at all.

For **Part (c)**, Candidates did not provide sufficient reasons for a 6 marks question. A few Candidates failed to make a recommendation. Some Candidates did not answer this question part at all while some answers were very short. Most Candidates who answered this question part were able to identify that WACC would reduce due to an increase in the amount of debt. Furthermore, some Candidates, were able to compare company's gearing ratio and the industry average.

Question 3

Question 3 centered on the computation of cash flow and liquidity (quick/acid test) which is fundamental for a newly set up electronic company. Better performing Candidates displayed an ability to articulate liquidity as compared to profitability for a going concern.

Part (a) Candidates did well for this question. Some Candidate failed to record that depreciation as a non-cash item. Only a few Candidates were able to illustrate the liquidity impact.

Part (b) was generally well answered across the cohort.

While many Candidates could identify that profits and cash flow are not the same thing in **Part (c)**, most Candidates did not specifically state that the increase in cash outflow could have serious consequences. Many Candidates could not identify the main problem with the exponential growth in the business, which was not merely the

mismatch of Accounts Receivable and Accounts Payable.

Part (d) was partially answered by most Candidates. Candidates should have elaborated their points in more details as this question is worth 8 marks. The mark allocation should be used as a guide to candidates as to the volume and depth of points expected.

Question 4

Question 4 concerned risk management culture in a freight forwarding company with an inconsistency of risk attitudes among the senior management in the firm. The question also tested the Candidates on best practice risk management processes in an organisation, that what is deemed to be an acceptable level of risk would differ between companies and industries, and the various risk management options. As a qualitative question, most Candidates were able to show a good knowledge of risk management in a company. Better performing Candidates provided more detailed descriptions of risks in organisation and the fact that an appropriate response depends on the risk appetite of the company. Some Candidates even illustrated different risk tools and highlighted actual loss, near-misses and scenario analysis (such as Monte Carlo simulation) and they were awarded additional marks by the marker.

Most Candidates performed fairly well for **Part (a)**. They were able to identify that risk management is about managing risk instead of eliminating risk. Most Candidates were able to point out that risk can never be fully be eliminated, however it can be mitigated. Some Candidates also commented on the HR director's assertions that higher risk leads to higher returns.

For **Part (b)**, most Candidates were able to discuss the marketing director's comment and commented on how the control environment and control procedures contribute to an organisation's risk management. Most Candidates were also able to point out that just having a good control environment is not sufficient. They commented on the importance of having control procedures and how this complemented the overall control environment. Overall, Candidates perform fairly in this question.

Part (c) was also answered adequately. Most Candidates were able to propose a suitable risk management process which included setting up a risk committee and function, introducing a risk manager and identifying and assessing the various forms of risks. Many Candidates were able to point out the importance of having an enterprise risk management system. However, there were also a few Candidates who failed to mention the monitoring of residual risk as well as the reporting and monitoring of risks more generally.

It was noted that there were a few Candidates who left the question completely blank which lead to a loss of marks. Most Candidates failed to point out that it is important to initially understand the risk appetite of the organisation.

Part (d) was poorly answered as not many Candidates were able to point out the 3 possible attitudes to risks namely risk seeking, risk neutral and risk averse attitudes. Most Candidates misunderstood this question and proceeded to explain the actions or responses to different forms of risks (accept, reduce or transfer the risks).